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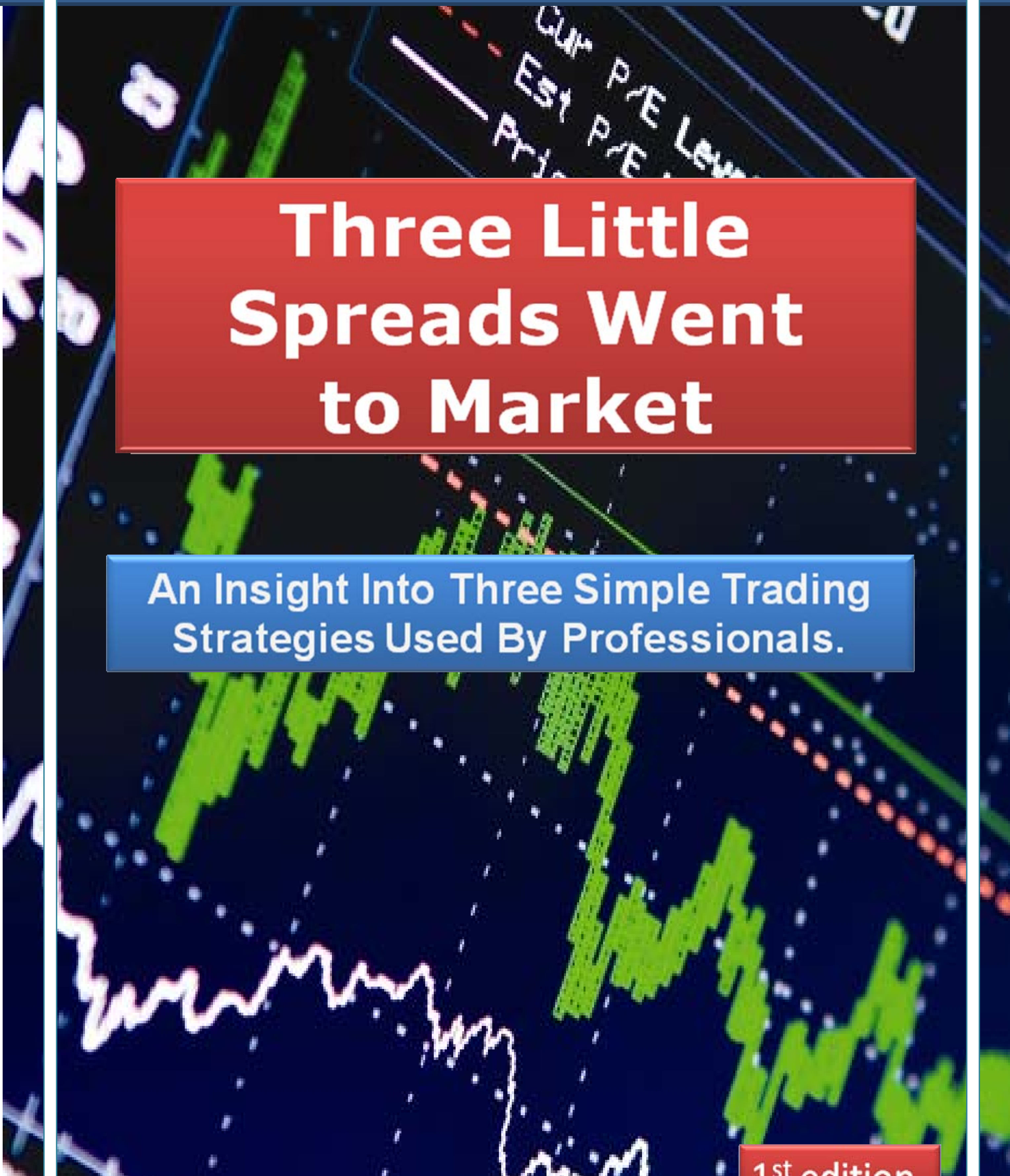


Three Little Spreads Went to Market

An Insight Into Three Simple Trading Strategies Used By Professionals.

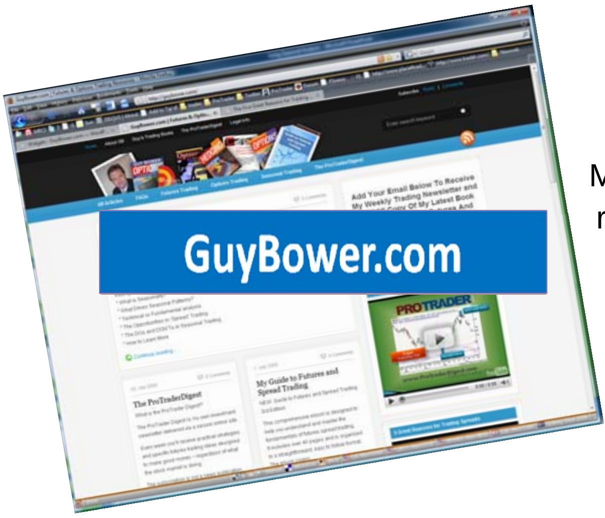
1st edition

Web Resources

Daniels Trading offer comprehensive, reliable and customer-focused commodity futures brokerage services to address all trading preferences.

Their website is also a great place for educational resources on anything relating to futures trading.

Check it out at: www.danielstrading.com



My personal site GuyBower.com has loads of free resources on futures, options and spread trading including free videos and articles.

See www.GuyBower.com

Acknowledgements

The charts in this eBook are kindly provided by eSignal. Over the years, I have used many different systems. One I have kept is eSignal. I absolutely love it. Thanks to Mina Delgado and all at eSignal for their ongoing support.

Legal Information

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INTRODUCTION

"May you live in interesting times"

This ancient Chinese curse is wheeled out every time the stock market sees a bit of volatility. If it is applicable to the stock market, then it's never been more applicable to the action we have seen in 2008 and 2009.

What makes it interesting is not so much that the stock market suffered massive falls or that people, unfortunately, lost money in stocks and property, but interest in commodity markets pushed to a new high.

The offshoot has been many people are now looking past the traditional asset classes of property and equities. People are now looking at alternatives that provide diversification, liquidity and of course the opportunity to profit.

As a professional trader, I see impact in the market. My 'little niche' is growing and I personally think it's fantastic. I first started learning about futures about 20 years ago thanks to a high school excursion to the Sydney Futures Exchange. Since then I have been hooked. I have since been involved in futures and/or options for most of those 20 years.

"People are now looking at alternatives that provide diversification, liquidity and of course the opportunity to profit."

In the last few years, and more so in the last year, I have seen a growing interest in commodity trading. It's exciting to see and I encourage everyone to have a good look at the opportunities.

That is what this eBook is about. I'm introducing three relatively straight forward strategies. They are all what you call "spreads". That is, they involve buying one futures contract and selling another to profit from a change in the price differential.

Spread trading is very much a niche, but as this eBook will show you, it can provide some fantastic trading opportunities. I will show you three little strategies that professional traders use few others know.

Yes, there is some jargon and yes, some concepts may make you scratch your head, but please persist. These strategies are not as complex as they first may seem. We are not talking rocket science or complex mathematics here. The mathematics involves addition and subtraction.

So let's get on with it. First of all, I have put together what I call a mini-glossary. These terms are particularly relevant to the following discussion. Then we look at the three spread strategies: the bull spread, the bear spread and the inter-market spread. This is the guts of this eBook. Then we look at where to get more info on how to trade spreads.

This eBook is aimed at a beginner level. However, some knowledge of futures trading would be advantageous.

MINI-GLOSSARY

Futures Contract

A futures contract is a commitment to make or take delivery of a specific quantity and quality of a given commodity [or asset] at a specific delivery location and time in the future. All terms of the contract are standardized except for the price, which is discovered via the supply (offers) and the demand (bids). This price discovery process occurs through an exchange's electronic trading system or by open auction on the trading floor of a regulated commodity exchange.

All contracts are ultimately settled either through liquidation by an offsetting transaction (a purchase after an initial sale or a sale after an initial purchase) or by delivery of the actual physical commodity. An offsetting transaction is the more frequently used method to settle a futures contract. Delivery usually occurs in less than 2 percent of all agricultural contracts traded.
Source: CME

Long position

Buying a futures contract with a view of it increasing in price means you have a long position or are "long the market".

Bullish

A bullish view means you expect the market price to go up.

Short position

Selling a futures contract before you buy it is called going short or short selling. This concept often confuses the newcomer as the reflex thought is "How can you sell something you don't own?"

The key to getting your head around this one is to remember futures contracts are simply agreements or bets on future price, and are generally not entered with a view of delivering or taking delivery of the physical commodity.

To enter a short position, you place an order to sell the futures contract or contracts. To close the position, you place an order to buy the contract(s) back.

Bearish

A bearish view means you expect the market price to go down.

Expiry or Delivery month

All futures contracts have a finite life. That is, there is some point in the future where they cease to trade. An exchange will make available a number of expiry months depending on demand for trading.

Some contracts call for physical delivery, some call for cash settlement, but very few people keep trading until the expiry date. Most contracts are closed out beforehand, so actual delivery or physical settlement is rare.

Margin

When you enter into a futures contract, you do not need to pay the entire contract value. Instead you are charged a deposit or “margin”. This margin varies depending on the particular contract. Margin rates tend to be a small fraction of the total contract value.

Futures Broker

To trade in futures contracts you need a futures broker. Some stock brokers may have futures trading departments but there are also many brokers that offer futures trading only.

Spread

In the context of this eBook, a spread is the simultaneous purchase (long) of one contract and sale of another (short) with a view of profiting from a change in the price differential.

To qualify as a spread, the contracts have to be related. For example, you could take on a spread position by buying (going long) wheat and selling (going short) corn.

STRATEGY #1: The Bull Spread

The bull spread consists of two futures contracts – one long (bought) and one short (sold). To create a bull spread, a trader would buy the nearer to expiry contract and sell short the distant contract.

Some examples of bull spreads are:

Long (bought) Contract	Short (sold) Contract
July 2010 Soybeans	September 2010 Soybeans
October 2009 Natural Gas	November 2009 Natural Gas
September 2009 Corn	December 2009 Corn

Generally speaking, a bull spread is a bullish position. That is, the spread is a strategy a trader would place when he/she is bullish on the market.

What Makes it a Bullish Position?

The answer to this one is very simple. When a market rallies, it is normally the nearer contract that leads the way. That is, the contract that is closer to expiry tends to move further than the more distant contract. So buying the nearer contract and selling the more distant contract is a bullish strategy.

As an example, let's have a look at Soybean Meal over the early part of 2009. The chart on the next page shows the price for December Soybean Meal and the bull spread price of Dec 2009 less July 2010 Soybean Meal.

You can see a bull market occurred in both Soybean Meal futures and the bull spread around same time.

In the market, traders can use the spread as an alternative to trading a single futures position. There are several reasons why a spread may be preferred:

- Significantly lower margins. That is, it costs less to place the trade.
- Reversals in spreads can often precede reversals in the underlying market. That is, the spread can act as an early warning indicator. This is evident in the chart above. If you look closely at points 1 and 2, you'll see the spread starting and finishing its bull run before the same move in the futures contract, made a move higher (point 1) and completed the rally (point 2) before the futures.
- Lower volatility. Generally speaking, a spread will carry less volatility or risk than trading outright futures. This can make spreads more attractive to the newcomer or conservative trader.

- Diversification. Lower margins means the trader can spread risk across more trading positions than would be possible when trading outright contracts.

When is a Bull Spread Not a ***Bullish*** Spread?

There are times when the underlying market may rally and the spread does not move in the same direction. The scenarios in which this can happen do vary from market to market.

However, as a general statement it is more often news or fundamental supply information that will push a bull spread higher whereas a technical or speculator-led rally may not see the spread move in the same direction as the underlying futures.

While this concept may at first seem complex, it's simply a matter of knowing what is driving a certain market. All that is needed here is a good source of trading information and market news.

STRATEGY #2: The Bear Spread

Like the bull spread, the bear spread consists of two futures contracts – one long (bought) and one short (sold). To create a bear spread, a trader would ***sell short*** the nearer to expiry contract and ***buy*** the distant contract.

Some examples of bear spreads are:

Short (sold) Contract	Long (bought) Contract
July 2010 Soybeans	**September 2010 Soybeans**
October 2009 Natural Gas	**November 2009 Natural Gas**
September 2009 Corn	**December 2009 Corn**

You can see the bear spread is simply the reverse of the bull spread. It stands to reason that a bear spread is a bearish position. That is, the spread is a strategy a trader would place when he/she is bearish on the market.

As with a rallying market, when a market is in a bear trend, the nearer contract tends to lead the way. As such a bear spread is an alternative to an outright short position.

Just like the bull spread, trader can prefer a bear spread in a bear market for reasons of lower margins, lower risk, better diversification potential and the fact a spread can signal a turn in the underlying market ahead of time.

So let's look at an example. The following page shows the same Soybean Meal chart as that in the bull spread example. Note the spread is plotted as Dec (near) less July (far). With the bear spread, being short the Dec (near) and long the July (far) contracts, the trader would want to see this spread ***fall*** to make a profit.

The thing to see in this chart is the fall in the spread as the outright December contract falls, as shown by the two arrows.

A Word on Margins

As mentioned earlier, one reason traders like to trade spreads is the lower margin requirements. In the Soymeal example, a margin for an outright futures contract would be $2000. For the above spread, it would be 10 percent of that, or $200. That's a big difference.

Now while the spread has less volatility than the futures contract, the spread still gives you far more bang for your buck. Of course that can work for you or against you depending on what the market does, but it remains an attractive feature of spread trading.

Great Markets for Trading Bull and Bear Spreads

This list is based on experience and general opinion. There may well be markets not listed here that offer good spread trading opportunity.

Energies:
Crude Oil, Heating Oil, Natural Gas

Grains:
Wheat, Corn, Soybeans, Soybean Oil, Soybean Meal

Metals:
Copper

Food & Fibre:
Cocoa, Coffee, Sugar

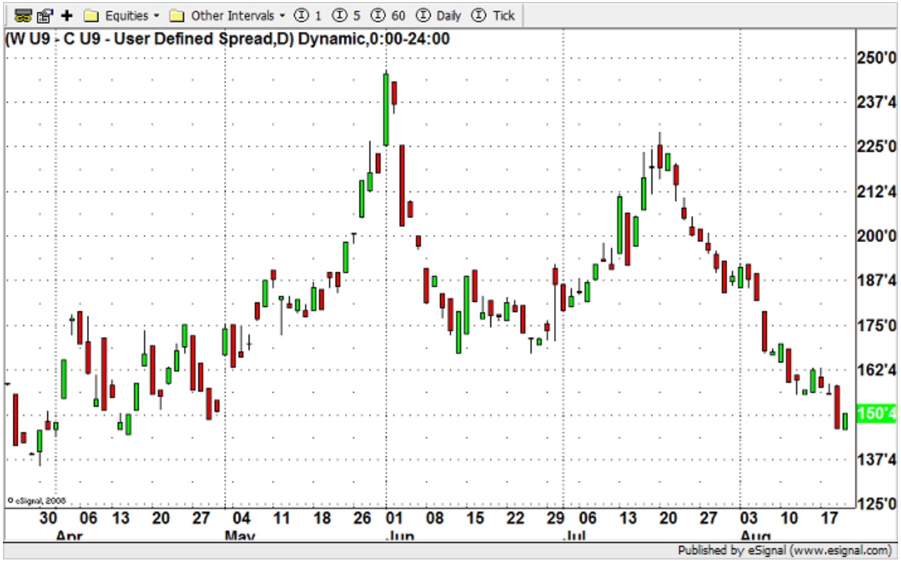
Financials:
Eurodollars, T-bonds, T-notes

Livestock:
Feeder Cattle, Live Cattle, Lean Hogs

STRATEGY #3: The Inter-Commodity Spread

Our third type of spread is an inter-commodity spread. It is a spread between two different but related markets.

Consider markets such as Wheat futures and Corn futures (below). They are similar commodities (being grains) and the prices are related. A move in one market can move the other, but they do not move one for one. *This creates spread trading opportunities.*



Consider another two markets: Live Cattle futures and Lean Hog futures (below). Both are livestock bred for human consumption. Both futures markets can move in line, but they can also have unique influences. *This creates spread trading opportunities.*

Another example is Silver and Gold (not pictured). Both are precious metals and as such tend to move in line with each other. But there are also influences that are unique to each market. *This creates spread trading opportunities.*

There are essentially three types of inter-commodity spreads:

1. Spreads between related commodities. All examples above fall under this category.

2. Spreads between a commodity and its derivatives. An example is Soybeans versus Soybean Oil and Soybean Meal. The Oil and Meal is derived from Soybeans. Another example is Crude Oil versus Heating Oil or Unleaded Gas. Heating Oil and Gas is derived from Crude.

3. The third type of inter-commodity spread is spreading the derivatives as outlined above. An example is Soy Oil versus Soy Meal, or Heating Oil versus Unleaded Gas. The prices of these contracts are related but the relationship does vary and therefore spread trading opportunities exist.

So let's look at an example. One spread I enjoy trading is Live Cattle versus Lean Hogs. As mentioned above, both are livestock bred for human consumption.

On one hand they are interchangeable foods. If the price of pork chops is too high, you may buy beef steaks instead for example. However, there are also some differences. Pork, for example, is used to make processed meats. These pork products have different demand characteristics from beef products.

As such, we have two related but different futures contracts. Therein lies the trading opportunity. For example, during the US summer holiday and driving season, demand for processed meats picks up relative to beef products. Conversely, during winter, demand for beef products tends to be stronger.

It's the shift in relative demand (or supply) that creates a seasonal variation in the spread price. Generally speaking, the futures contracts will start pricing in these end-product demand patterns well ahead of time, but with a well timed-trade, it is possible to make money from these patterns.

Facts About Inter-Commodity Spreads:

- Inter-commodity spreads tend to be a little more risky than the kind of bull and bear spreads we looked at earlier.

- Margins are still less than outright futures margins, but more than bull/bear spread margins.

- There is generally more profit potential from an inter-commodity spreads than a bull or bear spread. This is not always the case, but it is more often than not.

Great Markets for Trading Inter-Commodity Spreads

Metals:
Gold-Silver

Financial Spreads:
Combinations of 5yr note, 10yr note and 30yr bond.

Grains:
Combinations of Wheat, Corn and Soybeans
Soybeans Crush (Soybeans, Soy Oil and Soy Meal)

Livestock:
Combinations of Feeder Cattle, Live Cattle, Lean Hogs

Energy Markets:
Crack Spreads (Crude, Heating Oil, Unleaded Gas)

SUMMATION

This eBook presented three spread trading strategies. These are popular strategies among many professional and veteran traders.

Despite the low risk profile relative to trading outright futures, very few newcomers know of these strategies. The global financial crisis however is driving change. Private traders are starting to look beyond the equity and property investments and focus on opportunity instead of tradition.

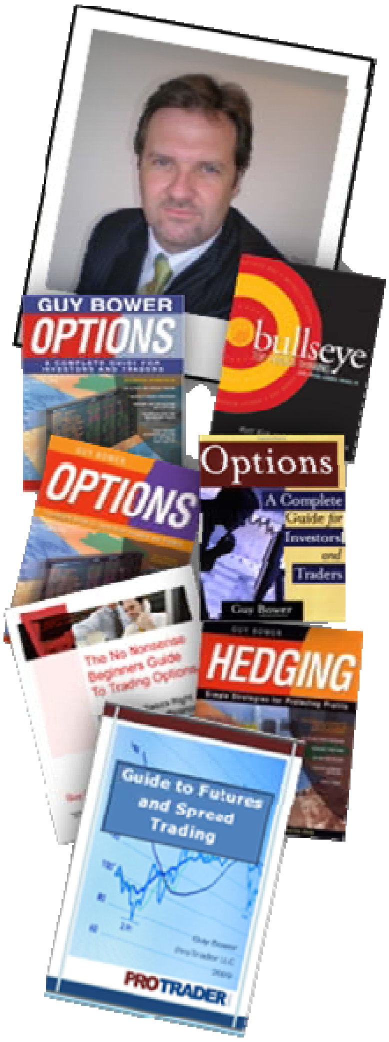
This is where spread trading can come alive. Spread trading offers some great opportunity and I hope this short eBook will whet the appetite of some new traders out there.

ABOUT THE AUTHOR

Guy Bower has been involved in the financial markets for close to 20 years.

He has worked as an analyst, broker, author and was a director of a managed futures fund. He has started and owned a commodity broking business and trading advisory service. He has also been a CEO of a stock broker and funds management business.

Guy now runs the ProTrader Digest newsletter. Using knowledge and experience, he delivers high probability trading opportunities.



BONUS OFFER

The ProTrader Digest newsletter identifies spread trading opportunities in the market. Trading updates cover:

- ✓ What markets to trade
- ✓ What to buy and sell
- ✓ Entry date
- ✓ Exit date
- ✓ The exact stop loss to use
- ✓ Contracts to trade
- ✓ The odds of success

For readers of this eBook, I am offering a 10% discount on the monthly subscription rate of us$199/month. To take up this offer, go to **www.ProTraderDigest.com** and when prompted type in the code: "**ebook**". This offer is limited.

It's that easy. However if you have more questions, please email at the address below. Best regards and good trading!

Guy Bower **Guy@ProTraderDigest.com**

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